

# Canadian Wheat Board Government Guarantees

## Economics & Competitiveness





Canadian Wheat Board  
Government Guarantees

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### Executive Summary

The CWB operates under the protection of three guarantees provided by the Government of Canada (GOC). The guarantees are referred to as the borrowing guarantee, export credit guarantee and the initial payment guarantee.

The borrowing guarantee provides the most tangible year-to-year financial benefit to the CWB. The borrowing guarantee allows the CWB to borrow "low" and lend "high". This gives the CWB the opportunity to earn interest revenue (referred to as net interest earnings) on all its borrowings. The net interest earnings have averaged around \$55 million during the last two years. Over the past seven years, the net interest earnings have been approximately \$80 million annually. Removing the borrowing guarantee will result in the immediate end of this source of revenue for the CWB.

Over the last six years, sales made on credit has ranged from 5.7% to 15.7% of total sales. In 2003/04, the CWB granted credit on 3.7% of its sales, or approximately \$150 million. Private financial institutions granted credit on an additional 3.6% of sales. Consequently, the export credit guarantee plays a small role in the overall sales plan of the CWB. Private lenders should be able to fill the void left when the CWB stops granting credit. The export credit guarantee is extremely important on existing account receivables. The GOC guarantees that the principal and interest will be paid in full to the CWB. As of July 31, 2004, this guarantee was worth \$5.2 billion.

The initial payment guarantee transfers the risk of a pool deficit to the GOC. The GOC accepts the risk when it approves the initial and adjustment payments. The current practice of the CWB is to set the initial payment at approximately 60-72% of the Pool Return Outlook. This initial payment is then adjusted upwards through the year as a greater portion of sales are made and/or world prices increase. In the process, the initial payment is increased to bring producer payment closer to the expected pool return. In the absence of the initial payment guarantee the CWB may have to reduce their initial payment and delay adjustment payments until there is greater certainty of the end pool value. However, setting the initial payment lower than they currently are could cause producer disapproval. The other options the CWB have include; increasing the use of risk management tools such as options, creating a financial reserve to cover pool deficits and shortening the pooling period.

Over the last 30 years, the CWB has had several pool deficits. The total shortfall from the deficits is \$1.2 billion. This works out to an average yearly value of \$40 million.

In summary, the borrowing guarantee provides the largest cash supplement to the CWB's operations. The export credit guarantee is rarely used these days to make new sales. It only becomes important when discussing outstanding accounts receivables. The initial payment guarantee is the foundation of the pooling system, the marketing focus of the CWB. Without the initial payment guarantee, the CWB will need to develop new business practices to address the changes.

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## Acronyms

ACF	Agri-Food Credit Facility
CGSP	Credit Grain Sales Program
CWB	Canadian Wheat Board
EEP	Export Enhancement Program
GOC	Government of Canada
PRO	Pool Return Outlook

## **1 Background**

The purpose of this study is to review the importance of the Canadian Wheat Board's (CWB) government guarantees. This study describes the guarantees, details how they work and summarizes their value. The impetus of the project was the August 2004 announcement by the Government of Canada (GOC) that government guarantees were negotiable under the current round of World Trade Organization discussions.

Most of the data for this study comes from the CWB's annual reports. The most recent annual report released by the CWB is for the 2003/04 crop year.

## **2 Three Types of Guarantees**

The CWB operates with support from three GOC guarantees. They are:

1. Export Credit Guarantee – the GOC assumes the risk of default payment on credit sales.
2. Initial Payment Guarantee – the GOC guarantees that initial payments made by the CWB are non-retractable.
3. Borrowing Guarantee – the GOC guarantees payment of money borrowed by the CWB, allowing the CWB to borrow at preferential rates.

The three guarantees each have their specific purpose, but are interconnected. This will be more evident as the study progresses.

## **3 Export Credit Guarantees**

The CWB has two types of credit programs: the Credit Grain Sales Program (CGSP) and the Agri-Food Credit Facility (ACF). The CWB also makes export sales where credit is granted by a third party private financial institution.

### **3.1 Credit Grain Sales Program**

The Credit Grain Sales Program is the vehicle used to facilitate credit sales to customers who can provide a sovereign guarantee of repayment from their central bank or ministry of finance. This program was very popular in the past when it was more common to have a single identity purchasing on behalf of a country. The CGSP has not been used in the last two years (2002/03 and 2003/04) to make new sales.

As of July 31, 2004 the accounts receivable for this program was \$5.2 billion. Of this, \$4.4 billion has been rescheduled over periods ranging from 5 to 25 years. The

rescheduling of this credit is under the terms agreed to by the GOC and is based on commitments to the Paris Club.<sup>1</sup>

A large sum of this credit is debt owed by Iraq. The amount owed by Iraq has been overdue since the Gulf War. As of July 31, 2004 Iraq owed \$772 million. It is unlikely that this debt will be paid by Iraq, however, the GOC leaves the balance with the CWB. This is a benefit for the CWB because they are required to borrow money to cover their accounts receivables, increasing the CWB's net interest earnings. The accounts receivable held by the CWB are guaranteed by the GOC. The GOC acknowledges this financial responsibility by reporting the CWB's accounts receivable balance as a contingent liability in the Public Accounts of Canada.

### 3.2 Agri-Food Credit Facility

The Agri-food Credit Facility was established to facilitate CWB grain sales made on credit. Over the past six years the ACF has been used to finance 3.1% of sales, or on average \$127 million a year. These sales are either made by the CWB or through accredited exporters. The GOC and the CWB evaluate each transaction together. The guarantee from the GOC is scheduled on a declining percentage of receivables. In 2003/04, the CWB's share of the credit risk was \$1.5 million or 1.5%-2% of the credit granted through the ACF.<sup>2</sup> At this point, the CWB states that they consider the balance collectible in its entirety and does not make allowances for default payment. The program has never experienced any defaults.

### 3.3 Third Party Credit

The CWB also enters into credit sales where a portion of the credit is granted by a third party. For example, the CWB grants 50% of the credit and the third party lends 50%. In this situation, the third party lender pays the CWB and the CWB does not incur any credit risk. The CWB reports these as credit sales because they jointly lend credit to the customer. However, the credit granted by the third party is not actually CWB credit sales. The CWB's role has been to assist the customer get credit. The third party lenders are not covered under the export credit guarantee. In 2003/04, third party credit represented half of the sales made on credit (this is equivalent to \$150 million or 3.6% of total sales).

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<sup>1</sup> The Paris Club is made up of 19 of the world's richest developed countries. It is the forum that brings these countries together to determine debt restructuring, debt relief and debt cancellation of indebted countries.

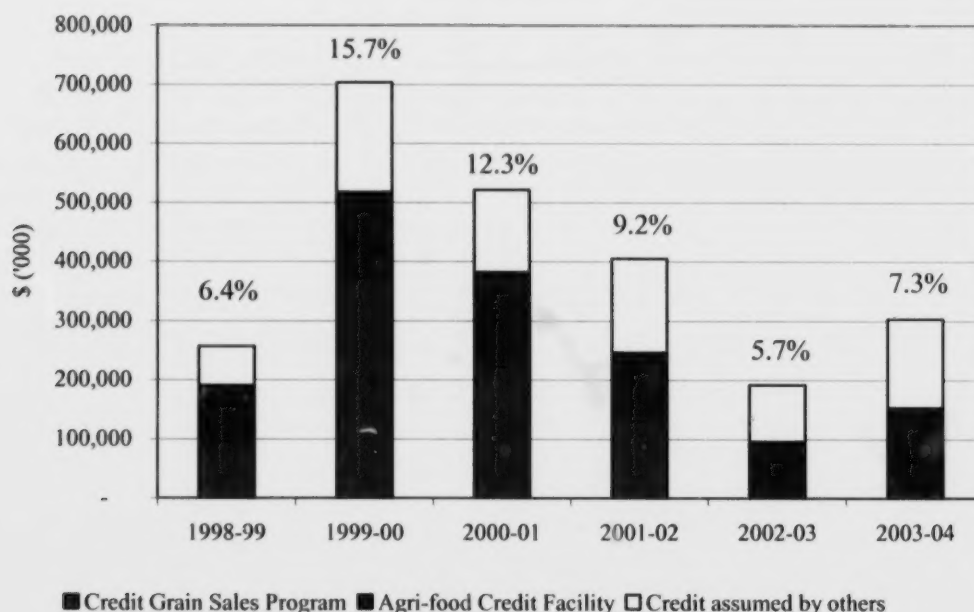
<sup>2</sup> CWB Annual Report, page 45.



### 3.4 Use of Export Credit Guarantees

Over the past six years, the use of export credits has ranged from 5.7% to 15.7% of sales. Over the two most recent years, sales made on credit have been equally divided between the ACF and external financing from financial institutions. There have been no sales made through the CGSP over the last two years. This suggests that export credit has not been a critical component of the CWB's marketing plan.<sup>3</sup>

Figure 1: CWB Credit Sales by Program and as a % of Sales



Source: CWB Annual Reports, Multiple Years

The export credit programs have largely been limited to sales to three countries. Over the last two years, Indonesia represents 44% of wheat credit sales (by volume) and Mexico 40%. Approximately 50% of this credit has been granted by the CWB and 50% from private financial institutions. Over the longer period of ten years, Iran has represented 57% of wheat sales requiring credit. Only 13,000 tonnes of barley has been sold using the credit programs over the last two years (2002/03 and 2003/04).<sup>4</sup>

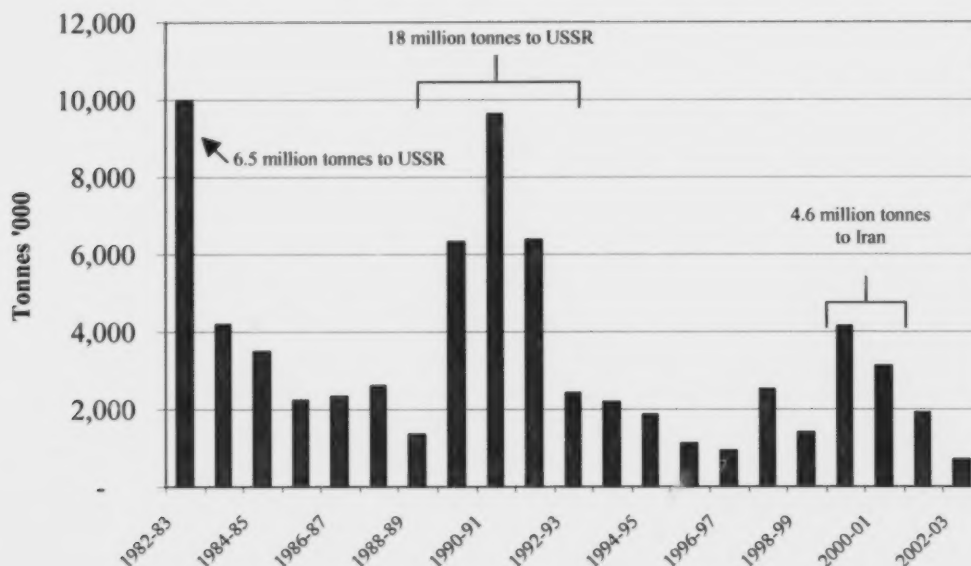
The following chart illustrates that the CWB made a considerable volume of sales on credit between 1989-90 and 1991/92. Over these three years, the CWB sold over 18 million tonnes of wheat and barley on credit to the former USSR. Since that time, the

<sup>3</sup> Data on export credit sales is provided in appendix Table A

<sup>4</sup> A list of credit sales by country is provided in appendix Table B.

volume of sales made on credit has declined substantially. The only exception was a larger than normal volume of credit sales to Iran between 1999/00 and 2000/01. The CWB's sales that are not made on credit are secured through the appropriate letters of credit from the customer's commercial lenders.

Figure 2: CWB Exports Sales made on Credit, Wheat and Barley



Source: CWB Annual Report, Multiple Years

Note: Includes credit granted by financial institutions

## 4 Initial Payment Guarantees

The initial payment the CWB pays producers is guaranteed by the CWB. If the pool return minus administrative expenses is less than the initial payment, the GOC is responsible for the shortfall. Historically, the wheat pool has incurred four deficits including 1968/69, 1985/86, 1990/91 and 2002/03. There have also been several deficits in the barley, designated barley and oats pools. Since 1975, the GOC has guaranteed \$1.2 billion in pool deficits.

### 4.1 Guaranteeing more than 'initial payments'

Although the guarantee is specifically referred to as the initial payment guarantee, it is actually more significant than that. At the beginning of a crop year the CWB announces the initial payment that will be made to producers upon delivery of their grain. During the last couple years, the initial payment has been set at 60% to 72% of the pool return outlook. As the year progresses, the CWB often increases the initial payment. These

increases are referred to as adjustment payments. Consequently, what is termed the initial payment later in the year includes the initial payment plus adjustment payments.

In 2002/03, the last year that the initial payment guarantee was triggered, the CWB made two adjustment payments in addition to the initial payment. For example, the initial payment for #1 CWRS 13.5% protein was \$155.20/tonne. The CWB made the first adjustment payment on September 17, 2002 for \$32/tonne and the second on November 27, 2002 for \$63/tonne. At the end of the year, the wheat pool closed with a \$9.86/tonne deficit (total of \$85 million). Consequently, the pool account easily covered the initial payment. The pool account was also able to cover the first adjustment payment. It was only the second adjustment payment that paid producers more than the due amount.

The 2002/03 annual report does not paint the picture as clear as it could. This is primarily because it is a summary of all the wheat sold in the pool account, not a specific grade and protein as provided in the previous paragraph. In the annual report, the CWB reports a wheat pool initial payment of \$215.61/tonne. The \$215.61/tonne is the average paid to producers upon delivery. It therefore includes adjustment payments and does not reflect the initial payment the CWB first set. This downplays the business decisions that ultimately led to the deficit.

According to the CWB's 2002/03 annual report, the adjustment payment was \$20.66/tonne, bringing the total paid to producers up to \$236.27/tonne. At the end of the year and after all sales had been made, the pool earnings for distribution was \$226.41/tonne. The shortfall between the pool value (\$226.41/tonne) and the amount paid to producers (\$236.27/tonne) of \$9.86/tonne was paid to the CWB by the GOC.

Consequently, the initial payment guarantee covers initial payments and adjustment payments. If the guarantee only covered the initial payment set at the beginning of the crop year, then the GOC would not have guaranteed the deficit in 2002/03.

#### 4.2 Historic Perspective of Initial Payments

Initial payments are set according to the CWB's best estimate of the value of the pool for the crop year, the Pool Return Outlook (PRO). The current practice is to set the initial payment at approximately 60-72% of the PRO.<sup>5</sup> It is set at this level in order to minimize the risk of paying producers more than the end pool value. Reviewing the data for #1 CWRS reveals that the initial payment (excluding adjustment payment) has almost always been less than the end pool value (see Figure 3). This includes 2002/03, the last time the initial payment guarantee was needed for the wheat pool. The deficits in 1985/86 and 1990/91 were due to the US Export Enhancement program's (EEP) impact

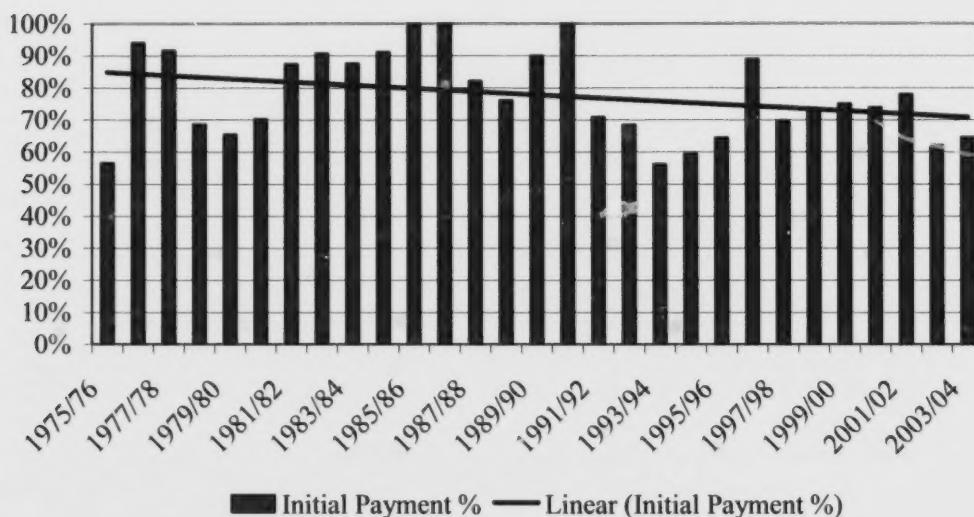
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<sup>5</sup> Calculated over the past five years using the initial payment for August 1<sup>st</sup> and the PRO for the end of July.

on world wheat prices.<sup>6</sup> The 1990/91 deficit was also influenced by the Gulf War (Schmitz and Furtan, 1999).

Consequently, there is only marginal risk that the pool account would be less than the initial payment announced at the beginning of the crop year. The larger risk is associated with guaranteeing the adjustment payments. The adjustment payments increase the initial payment as the year progresses and a greater share of the crop is sold or when world prices are increasing. In either case, the CWB increases producer payments, bringing the initial payment closer to the expected final pool price.

Figure 3: Initial Payments on #1CWRS as a Percentage of Total Payments\*



Source: CWB Annual Reports, Multiple Years

\* Data from 1992/93 to present is for #1 CWRS 13.5% protein.

#### 4.3 Economic Value of Initial Payment Guarantee

Putting an economic value on the initial payment guarantee has been a theoretical task, limited to one or two academic studies and the US Department of Commerce. The most common valuation is to use Asian or European option valuation theory. In essence, the initial payment is equivalent to the strike price because it establishes the minimum price that producers will receive for their wheat or barley. It is argued that the GOC through its guarantee is paying the premium for the put option, with the CWB being the sole beneficiary. A detailed quantitative analysis of the initial payment guarantee is available in Unterschultz and Novak (1999).

<sup>6</sup> In 1986/87, there were no additional payments made for #1 CWRS. However, the wheat pool account did not run a deficit because of the surplus associated with other wheat types.

The following table provides a listing of each of the pool deficits experienced since 1975. In total, the CWB has incurred \$1.2 billion in pool deficits. The largest deficit year was 1990/91 when the CWB was deficit in the wheat, durum and barley pool totaling \$744 million. The 1990/91 deficits represent 63% of the total deficits since 1975.

Table 1: CWB Deficits, 1975/76 to 2003/04

	Wheat	Durum	Barley	Designated Barley	Oats	Total	% of Total
				----- \$ -----			
2002/03	85,388,000					85,388,000	7.2%
1990/91	673,375,352	69,612,457	956,713			743,944,522	62.7%
1988/89					32,361,239	32,361,239	2.7%
1986/87			92,543,884	17,970,279		110,514,163	9.3%
1985/86	22,994,777		171,370,689		6,919,810	201,285,276	17.0%
1982/83			5,544,235			5,544,235	0.5%
1981/82					2,291,454	2,291,454	0.2%
1979/80					778,942	778,942	0.1%
1977-79					4,779,376	4,779,376	0.4%
Total	781,758,129	69,612,457	270,415,521	17,970,279	47,130,821	1,186,887,207	

Source: CWB Annual Reports, Multiple Years

## 5 Borrowing Guarantee

Under section 19 of the *Canadian Wheat Board Act* it states that the GOC guarantees the borrowings of the CWB. With this guarantee, lenders and investors rate the CWB's indebtedness as very secure. Consequently, the lending rate the CWB is able to borrow at is only slightly higher than borrowings of the GOC.<sup>7</sup> These interest rates are lower than commercial rates. In order to qualify for the borrowing guarantee the CWB must submit an annual borrowing plan to the Minister of Finance for approval of its terms and conditions.

### 5.1 CWB's Borrowing Needs

The CWB borrows money for three reasons: to finance accounts receivable, to finance producer payments and for making financial investments. The primary reason the CWB borrows is to pay accounts receivables. Over the past several years, the CWB has borrowed approximately \$7 billion at any one time to finance its accounts receivables and other borrowing needs.

As of July 31, 2004, the CWB's accounts receivables were \$5.3 billion. These accounts receivables are related to sales made on credit over the past twenty-five years (explained

<sup>7</sup> Standard and Poor's Inc. rates the CWB's credit rating as AAA, however, have recently changed the outlook on the rating from stable to negative. The CWB credit rating outlook was lowered because the government guarantees were negotiable at the 2005 WTO discussion in Hong Kong.

in the export credit guarantee section). The CWB needs to borrow in this situation because they pay producers the initial payment when they deliver the grain, but do not receive payment for several months or years (until the credit is paid). Consequently, they require borrowed money to finance their transactions.

The CWB also borrows to finance producer payments for the current crop year. Unfortunately, data is not available to track the daily or monthly borrowing requirements of the CWB. Over the last five years, the July 31<sup>st</sup> balance of borrowings associated with day-to-day operations has ranged from \$57 to \$527 million. This amount will vary from year-to-year depending on the CWB's marketing program. The CWB's borrowing requirements for day-to-day operations is similar to the accounts receivable explanation above. The difference is that payment is received much quicker and the CWB is not required to roll over its borrowings year-to-year.

The CWB's third use of borrowing is to finance investments. The CWB states that it makes investments for the purpose of cash management. In the last two years the CWB has ended the year with larger than normal investment balances. In 2002/03, the CWB held \$1.46 billion in investments and \$1.60 billion in 2003/04. This is up from an average of \$200,000 in the years 1999/00 to 2001/02.<sup>8</sup> Details on the nature of the investments are not provided and should be questioned.

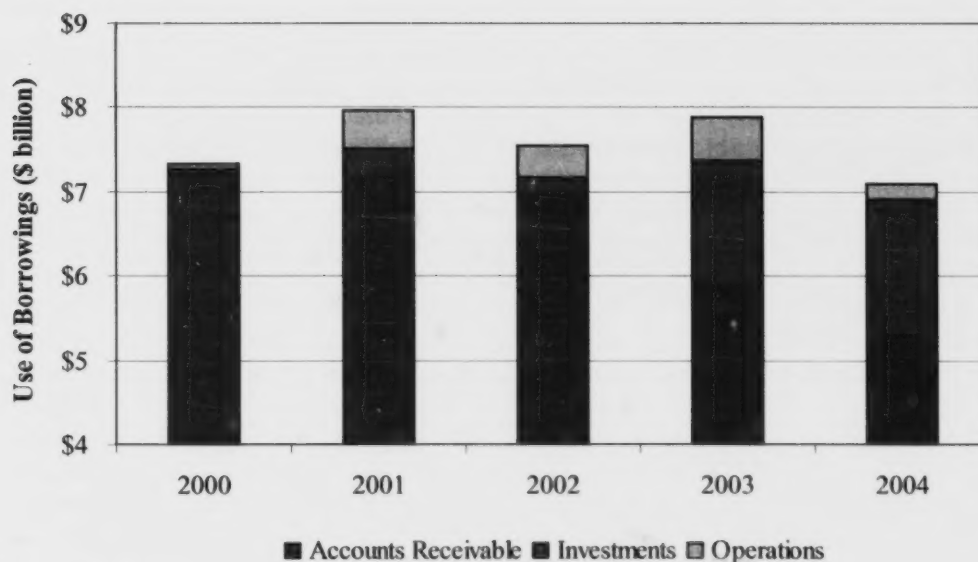
The borrowing guarantee creates an interest spread that generates the CWB a net interest earnings. Consequently, the more the CWB borrows, the higher its net interest earnings. Over the last two years, the CWB's accounts receivables have been declining. This reduces the necessary amount of borrowings the CWB must make, reducing net interest earnings. The CWB has appeared to have responded to this by making substantial financial investments made with borrowed money. Consequently, the CWB has not reduced the amount it borrows and has been able to maintain a significant balance of net interest earnings.

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<sup>8</sup> Data on the CWB's accounts receivables, investments and borrowings is provided in appendix Table C.



Figure 4: CWB's Use of Borrowings



Source: CWB Annual Reports, Multiple Years

## 5.2 Net Interest Earnings

The financial benefit of the export credit guarantee and the borrowing guarantee is captured by the CWB's *Net Interest Earnings*. This is how the CWB describes it.

*"Net Interest Earnings of \$56.1 million were due primarily to the net interest earned on amounts owed to the CWB on credit grain sales made under the Credit Grain Sales Program and the Agri-food Credit Facility. When the CWB sells grain on credit, it must borrow an equal amount to facilitate payments to farmers and conduct ongoing operations. The CWB is able to borrow at interest rates lower than those extended to the credit customer. As a result, the CWB earns an interest 'spread' "* CWB, 2003/04 Annual Report

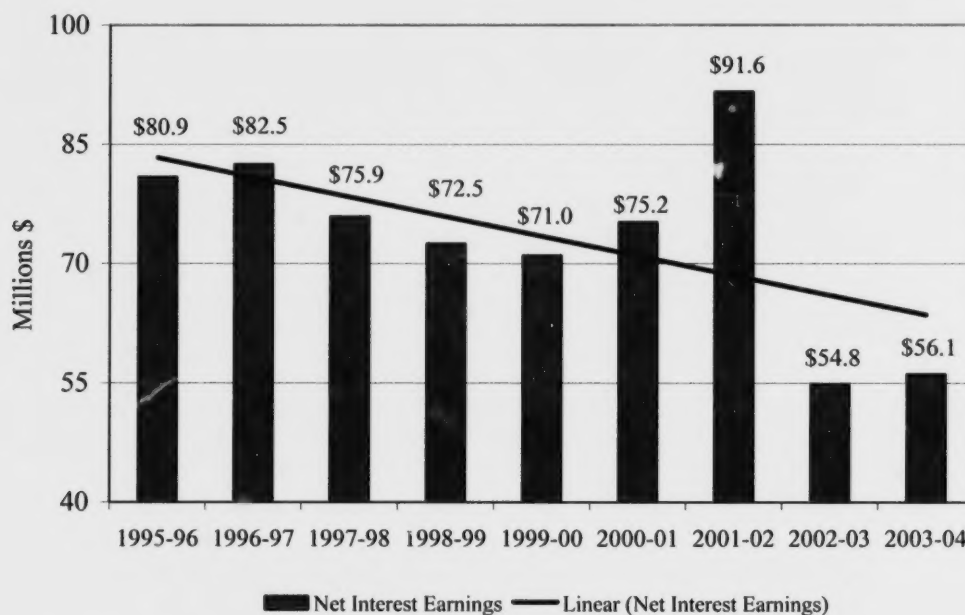
The interest earned by the CWB is based on the amount owed to the CWB and the interest spread between the preferential rate they borrow at and commercial rates they lend at. The larger the accounts receivable, the larger the net interest earnings. The net interest earnings reflect the interest the CWB charges on its accounts receivables and is not the actual interest payment received. The CWB has stated that this follows standard accounting practices.

The following graph charts out the CWB's net interest earnings since 1995-96. Evident from the graph is the significant drop in net earnings over the past two years. The

average net earnings for 2002/03 and 2003/04 was \$55.5 million. The average for the seven years prior to that was \$78.5 million.

In 2001-02 the CWB reported net interest earnings were \$91.6 million, significantly higher than average. This is partially due to the rapid decline in interest rates.<sup>9</sup> Borrowings are usually financed for shorter periods than the accounts receivable. Therefore, borrowings are refinanced at lower interest rates sooner than credit is rescheduled at lower rates.

Figure 5: CWB Net Earnings



Source: CWB Annual Reports, Multiple Years

The CWB only started reporting their source of net interest earnings in 2001/02.<sup>10</sup> In that year, they began to itemize interest earned and cost of borrowings for their accounts receivables. Previously, net interest earnings were reported on a net basis, with occasional reference to whether they were earned on accounts receivable or the pool account.

The majority of the net interest earnings are derived from accounts receivable, primarily the CGSP. Only a small percentage of the CWB's current sales are made on credit,

<sup>9</sup> The US Federal Funds Rate fell from 3.79% on August 1, 2001, to 1.72% on July 31, 2002. The Bank Rate in Canada was 4.5% on August 1, 2001, declining to 3% on July 31, 2002. The Canadian Bank Rate reached as low as 2.25% during the period, before increasing back to 3%.

<sup>10</sup> The CWB changed its reporting policy upon recommendation from the Auditor General (February 27, 2002).



consequently the ACF's share of interest earnings and expenses are very small. The CWB's annual report provides data that states that over the last four years, 96.8% of net interest earnings were made on accounts receivables. This has ranged from 93.7% to 104%. A large percentage of the accounts receivable have been rescheduled and date back 10 to 25 years.

The CWB has a positive net interest earnings on accounts receivable simply because they can borrow at preferential rates and grant credit at commercial rates. The CWB annual report also makes reference to the fact that interest rates declined during most of this period. This widened the spread between the borrowing and lending rate, increasing net earnings. In 2000/01, the accounts receivables were \$7 billion and interest earnings were \$492 million. This works out to an average lending rate of 6.9%. The CWB's interest expense incurred borrowing the funds was \$422 million. In 2003/04, the average interest rate the CWB charged on its accounts receivables was approximately 2.3%.<sup>11</sup>

The interest revenue and expense on the pool account is based on the period between when initial payments are made and the date the CWB is paid for the sale of the grain. The CWB earns a positive return by borrowing to pay for the initial payment (at preferential rates) and lending on credit at higher rates. In 2002/03, the CWB reported a net interest loss on the pool account of \$4.5 million. This occurred because the CWB ran a deficit, forcing the CWB to borrow money to pay producers. This was an additional cost to the CWB.

A special note is made that the CWB only reports a net interest earning (loss) on money borrowed to finance the current years pool account. The CWB provides details on interest revenue and expenses for credit sales and other borrowing. There is no apparent reason why the CWB would treat the pool account differently.

The category 'other interest revenue and expenses' is largely earned on non-credit sales when customers do not make payment on the specified dates. Normal delays range from 1-10 days.

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<sup>11</sup> Approximate accounts receivable of \$5.6 billion and \$131.5 million in interest earnings.

Table 2: Net Interest Earnings Calculations

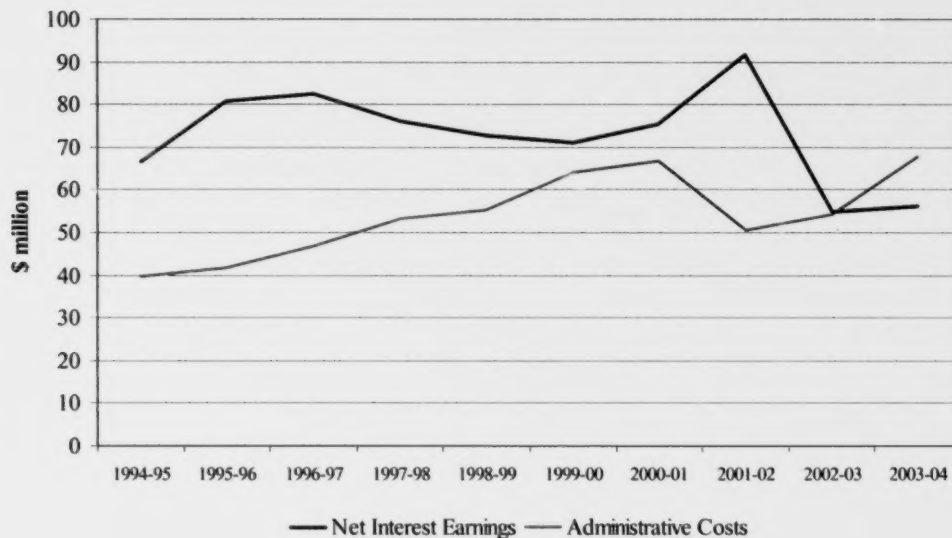
	2000-01	2001-02	2002-03	2003-04
<i>Interest on Credit Sales:</i>		----- \$'000 -----		
Interest Revenue on Credit Sales Receivable	492,448	273,848	173,626	131,520
Interest Expense on borrowings used to finance credit sales receivables	421,946	187,907	116,623	78,305
Net Interest on Credit Sales	70,502	85,941	57,003	53,215
Net Interest Revenue (expense) on pool account balances	6,312	5,105	(4,455)	410
<i>Other Borrowing:</i>				
Interest Revenue	5,141	4,630	5,126	5,321
Interest Expense	6,735	4,037	2,858	2,821
Net Interest on Other Borrowing	(1,594)	593	2,268	2,500
Total Net Interest Earnings	75,220	91,639	54,816	56,125

Source: CWB Annual Reports, Multiple Years

During the last couple years, the CWB has explained in their annual reports that the decline in net interest earnings is partially caused by a lower accounts receivable balance. The CWB explains that Poland and Russia have made sizable repayments in 2002/03 and 2003/04. This reduces accounts receivables, reducing net interest earnings. Lower interest rates are also reported as reducing the CWB's net interest earnings.

The CWB has on several occasions reported that net interest earnings cover their administrative costs and that it operates at no cost to producers. This has been true up until 2003/04, the first year that net interest earnings have been less than the CWB's administrative costs. As the CWB receives payment against accounts receivable from countries such as Poland, Russian and Iran, they have less means to earn net interest earnings. This means that in the future producers will bear the cost of the CWB more and more each year.

Figure 6: CWB's Administrative Costs vs Net Interest Earnings



### 5.3 Loss of Borrowing Guarantee and Day-to-Day Financing

The CWB borrows money daily to meet their cash flow needs for the period between the time they pay producers the initial payment and when they are paid for sold grain. Without the guarantee, the CWB would pay a higher interest rate on its borrowings than it currently does. The volume of borrowings the CWB would require would be the greatest at the beginning of the crop year. As the year progresses, the CWB should be able (or will be increasingly able) to meet its cash flow needs through the cash reserve in its pool accounts.

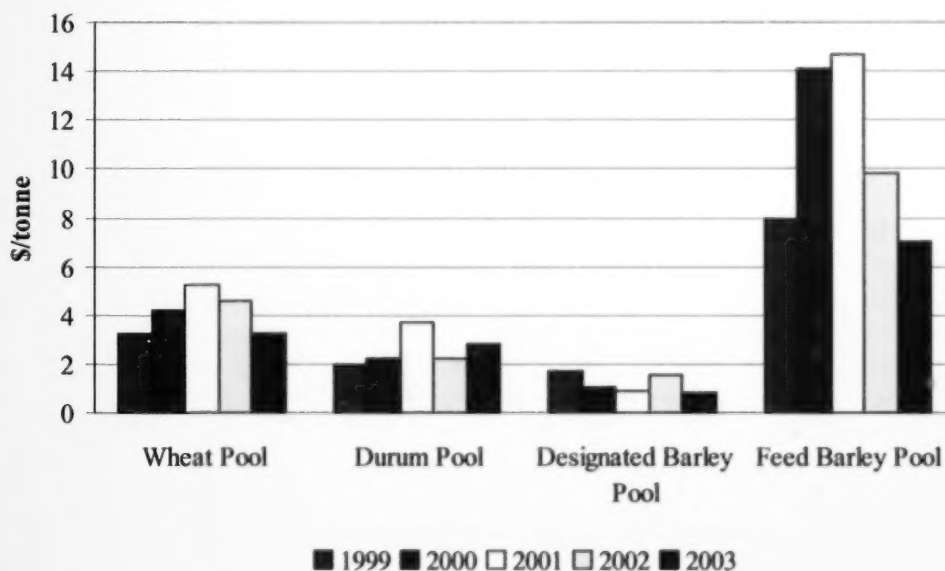
For example, in 2002/03 the initial payment paid for #1CWRS 13.5% upon delivery was \$155.20/tonne. Sixty days or so later, the CWB would have the wheat at port, loaded and received payment of \$250.20/tonne.<sup>12</sup> Assuming a shipment size of 10,000 tonnes, the amount required to pay producers the initial payment was \$15.5 million. The amount received on the sale of the wheat was \$25.02 million. Consequently, once the payment was received on the first shipment there would be \$10 million in the pool account to fund the initial payment of subsequent deliveries. The CWB's administrative cost on 10,000 tonnes was approximately \$40,300.

<sup>12</sup> \$250.20/tonne was the final price paid for #1CWRS 13.5% protein.

#### 5.4 Loss of Borrowing Guarantee on Pool Accounts

The loss of the borrowing guarantee will impact each of the pool accounts differently. This is because the CWB allocates the net interest earnings to the pool account that the original credit sales were made. If the interest net interest earnings are linked to accounts receivables from barley sales, then the barley pool account receives the earnings.<sup>13</sup> The figure clearly shows that net interest earnings have influenced the CWB's barley pool the most. Without the net interest earnings, the CWB's barley prices would be considerably lower and bids from the livestock industry would be more competitive. In other words, the borrowing guarantee gives the CWB a false competitiveness in the feed barley market, increasing the amount of barley that is exported and not directed to the domestic livestock industry.

Figure 7: Net Interest Earnings per tonne, by Pool Account



The wheat pool also benefits from a \$3-5/tonne net interest earnings distribution. The livestock industry is again set at a disadvantage because the CWB uses the net interest to increase its feed wheat bid. This results in a larger volume of feed wheat being directed to international markets than otherwise would have occurred without the net interest earnings. In the absence of net interest earnings, bids from the local livestock industry would become more competitive vis-à-vis the international market.

<sup>13</sup> This is against the Auditor General's recommendation to equally distribute the net interest earnings.

### 5.5 CWB's Borrowing Programs

The following is a summary of the borrowing programs used by the CWB to source funds. All financing is through issuance of commercial paper and notes. Each funding program meets a specific need, either being the currency of the note or the term to maturity. For example, the CWB issues the Canadian Commercial program with terms ranging from 1 to 365 days for shorter-term borrowing. The Euro Medium Term Note program is used to borrow over longer durations and other currencies.

Table 3: CWB's Borrowing Programs

	Canadian Commercial Paper Program	U.S. Commercial Paper Program	Euro Commercial Paper Program	Euro Medium-Term Note Program
Typical Holdings	\$C 1.5-2.5 B	\$US 1.5 – 2.5 B	\$US 1-2 B	Not available
Term to Maturity	1 to 365 days	1 to 270 days	7 to 364 days	Not available
Terms of Issuance	1 to 12 months	1 to 9 months	1 to 12 months	5 – 15 years
Minimum Size	\$100,000, then \$1,000 increments	\$US 100,000, then \$1,000 increments	\$US 100,000, then \$1,000 increments	Not available

Source: CWB website.

## 6 Accounts Receivable and the Exchange Rate

The accounts receivable reported in the CWB's annual report has declined significantly over the past two years. Approximately 75% of the CWB's accounts receivables are due in US dollars. The remaining balance is due in Canadian dollars.

Over the last couple of years, the Canadian dollar has increased in value relative to the US dollar. This has reduced the accounts receivables held by the CWB. On July 31, 2002, the CWB's accounts receivable due in US\$ was \$US3.3 billion. On July 31, 2004, the balance was \$US3 billion. This represents a payment of \$US378 million towards accounts receivable.<sup>14</sup>

In its annual reports the CWB converts all accounts receivables to C\$. Comparing the accounts receivables between 2002 and 2004 reveals that the amount due declined by \$C1.35 billion. This is largely due to the difference in exchange rates between the two periods. Consequently, the CWB received \$US378 million but once converted to C\$, they report that accounts receivable had declined by \$C1.35 billion.

<sup>14</sup> Yearly data on the CGSP accounts receivable is provided in appendix Table D.

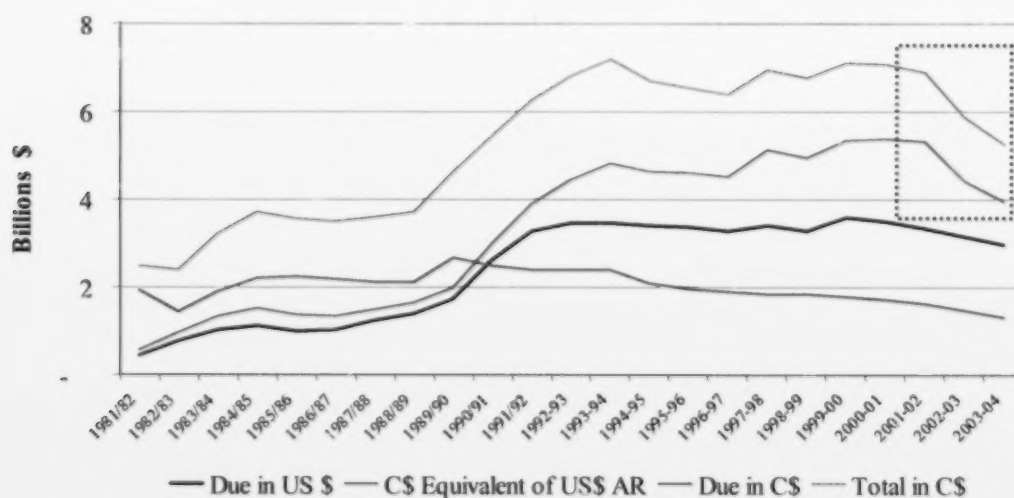
Table 4: CWB's Accounts Receivable

	July 31, 2002	July 31, 2003	July 31, 2004	Change in AR 2002 to 2004
		----- \$ millions -----		
AR Due in US\$	3,335	3,125	2,958	(378)
C\$ Equivalent of US\$ AR	5,280	4,390	3,932	(1,347)
AR Due in C\$	1,595	1,457	1,286	(309)
Total Accounts Receivable (C\$)	6,874	5,847	5,218	(1,656)

Source: CWB Annual Reports, Multiple Years

Consequently, the significant decline in accounts receivable (and consequently its assets) was due to change in the Canadian/US exchange rate. How the CWB manages foreign exchange risk requires further investigation. Revenue from currency swaps is not apparent on the CWB's income statement. The graph shows the balance of the accounts receivable due in Canadian dollars, US dollars and the total amount in Canadian dollars, highlighting the fact that the drop in accounts receivable is largely due to the exchange rate changes and not customer payments.

Figure 8: CWB Credit Grains Sales Program, Accounts Receivable



Source: CWB Annual Report, Multiple Years



## **7 U.S. Commerce Department Valuation of Guarantees**

The Commerce Department separated the CWB's government guarantees into three components in its remand determination.<sup>15</sup> This was required following a ruling that the government guarantees were individual subsidies although they were connected or dependent on each other. The Commerce Department quantified the countervailable subsidy for the borrowing guarantee to be 1.14% of the price of hard red spring wheat. The countervailable subsidy for the initial payment guarantee was estimated to be 1.05%. The export credit guarantee was not quantified because it was tied to third-country exports and not the US market.

Using the CWB's 2003/04 revenue from all pool accounts of \$4.1 billion as the base, the countervailable subsidy of 1.14% is valued at \$46.7 million. The initial payment guarantee is valued at \$43.1 million, for a total of \$89.8 million. This does not quantify the value of the export credit guarantee.

On October 5, 2005 the US International Trade Commission announced that the US imports of HRS wheat were not injurious to US wheat producers. They stated that without an affirmative injury determination, the countervailing duties had no basis in US law and were to be removed.

## **8 CWB's Statements**

The CWB has publicly stated that if the government guarantees were removed, farmers would bear the brunt of the \$60-100 million loss (Schmidt, 2005, Calgary Herald). This is similar to the net interest earnings reported by the CWB. The CWB has not disclosed if this is the rationale behind their estimate.

The CWB's statement that they should be compensated for the loss implies the outstanding accounts receivable are something the GOC has granted them and that they will always be there to create a steady stream of income. Consequently, the CWB is calling for compensation of a revenue stream that is not related to the CWB's mandate but a historic income that has been created from accounts receivable.

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<sup>15</sup> The Commerce Department's ruling was part of the North Dakota Trade Commission's petition to the United States Trade Representative to investigate the Canadian Wheat Board

## 9 Summary

The borrowing guarantee provides the most tangible year-to-year financial benefit to the CWB. The borrowing guarantee allows the CWB to borrow "low" and lend "high". The net interest earnings have averaged around \$55 million during the last two years. Over the past seven years, the net interest earnings have been approximately \$80 million annually. Removing the borrowing guarantee will result in the immediate end of this source of revenue for the CWB.

The size of the net interest earnings is dependent on the CWB's accounts receivables, which is reflective of the past use of the export credit guarantee. Without the export credit guarantee, the CWB would not have been in a position to accumulate such a balance of accounts receivables.

Historically, the CWB has used the export credit guarantee extensively. This is apparent in the volume of sales to the former USSR, Poland, Iraq and Iran. Over the last ten years Iran, Indonesia and Mexico have been the largest users of the credit program.

Eliminating the export credit guarantee would mean that the CWB would likely discontinue granting credit. Countries such as Indonesia and Mexico would have to secure their own credit. Over the last six years, sales made on credit has ranged from 5.7% to 15.7% of total sales. In 2003/04, the CWB granted credit on 3.7% of its sales. Private financial institutions granted credit on an additional 3.6% of sales. Consequently, the export credit guarantee play a small role in the overall sales plan of the CWB. Private lenders within Canada and the customers home country will fill the void left when the CWB stops granting credit.

The importance of export credit guarantees on outstanding account receivables is extremely important, being valued at \$5.2 billion on July 31, 2004. The GOC currently reports the CWB's accounts receivables as a contingent liability in the Public Account.

The initial payment guarantee transfers the risk of a pool deficit to the GOC. This GOC agrees to accept the risk when it agrees to the initial and adjustment payments. The current practice of the CWB is to set the initial payment at approximately 60%-72% of the PRO. This initial payment is then adjusted upwards through the year as a greater portion of sales are made and/or world prices increase. In the process, the initial payment is increased to bring producer payment closer to the expected pool return. In the absence of the initial payment guarantee the CWB may have to reduce their initial payment and delay adjustment payments until there is greater certainty of the end pool value. The other options the CWB have include increasing the use of risk management tools such as options in order to protect downward price movement, creating a financial reserve to cover pool deficits or shortening the pool account.



Over the last 30 years, the CWB has had several pool deficits. The total shortfall from the sum of the deficits is \$1.2 billion. This works out to an average yearly value of \$40 million.

In summary, the borrowing guarantee provides the largest cash supplement to the CWB's operations. The export credit guarantee is rarely used these days to make new sales. It only becomes important when discussing outstanding accounts receivables. The initial payment guarantee is the foundation of the pooling system. Without the initial payment guarantee the CWB will need to develop new business practices to address the changes.

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## Appendix

Table A: Credit Sales by Program

('000)	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
			----- \$'000 -----			
Credit Grain Sales Program	95,473	371,671	222,463	131,554	-	-
Agri-food Credit Facility	95,378	145,868	159,431	114,717	95,750	153,155
Credit assumed by Others	65,961	185,798	139,184	158,568	95,750	149,965
<b>Total Credit Sales</b>	<b>256,812</b>	<b>703,337</b>	<b>521,078</b>	<b>404,839</b>	<b>191,500</b>	<b>303,120</b>
<b>Total Sales</b>	<b>4,026,703</b>	<b>4,482,438</b>	<b>4,227,675</b>	<b>4,379,269</b>	<b>3,339,872</b>	<b>4,136,168</b>
Credit as a % of Total	6.4%	15.7%	12.3%	9.2%	5.7%	7.3%

Source: CWB Annual Reports, Multiple Years

Table D: CWB Export Sales under Credit Agreements ('000 tonnes)

000 tonnes	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
<b>Wheat/Durum</b>																						
Algeria					145	764	326	605	852	363	545	745										
Bangladesh						104																
Brazil	1503	1205	1145	981	775	445		200	304	660	286	590	357	264	89	89	92	19				30
Chile																	11					
Colombia				21	22		163															
Cuba								80									10					
Egypt		614	450	464	208																	
Ethiopia						100																
Germany, East	308	73	170	48																		
Guatemala																						28
Haiti			25																			
Indonesia																55	394	702	836	415	199	658
Iran												830	1,181	806	743	1,892	449	2,931	1,654	883		
Iraq	74	608	367	347	691	880	724	783														
Israel		18	99	25	95	18																
Jamaica	23	22	24	39	38	39	39	59	54	73	53	31	20									
South Korea																60	98		10			
Mexico	189	276			152	153												104	397	479	417	358
Pakistan											94		208		47	196	150					
Peru		25	26														131	211	213	114	59	109
Turkey																						71
Uzbekistan													97									
USSR	5095							3447	7223	4915	1314											
Yemen									23													
	7,642	2,841	2,306	1,925	2,126	2,503	1,252	5,174	8,456	6,011	2,292	2,196	1,863	1,070	879	2,292	1,335	4,027	3,110	1,891	675	1,254
<b>Barley</b>																						
China																203	59	85	21			13
Germany, East	600	832	798	149																		
Iran														53	47							
Mexico	22	63	41															18				
Iraq		197	135			111	115	224														
USSR	1427							914	1194	372	148											
Israel	252	231	187	145	198																	
	2,301	1,323	1,161	294	198	111	115	1,138	1,194	372	148	-	-	53	47	203	59	103	21	-	-	13
<b>Total Credit Sales</b>	9,943	4,164	3,467	2,219	2,324	2,614	1,367	6,312	9,650	6,383	2,440	2,196	1,863	1,123	926	2,495	1,394	4,130	3,131	1,891	675	1,267

Source: CWB Annual Reports, Multiple Years

Table C: CWB Use of Borrowings, Reported on July 31<sup>st</sup>

	2000	2001	2002	2003	2004
	----- \$C '000 -----				
Borrowings	\$ 7,326,027	\$ 7,976,759	\$ 7,550,657	\$ 7,891,565	\$ 7,086,793
Accounts Receivable	\$ 7,206,991	\$ 7,179,353	\$ 6,965,448	\$ 5,903,578	\$ 5,311,103
Borrowing less AR	\$ 119,036	\$ 797,406	\$ 585,209	\$ 1,987,987	\$ 1,775,690
Investments	\$ 61,818	\$ 331,783	\$ 214,295	\$ 1,460,093	\$ 1,604,658
Operations*	\$ 57,218	\$ 465,623	\$ 370,914	\$ 527,894	\$ 171,032

Source: CWB Annual Reports, Multiple Years

\* Calculated as Borrowings less AR and Investments.

Table D: CWB's Credit Grain Sales Program Accounts Receivables

	Due in US \$	CDN Equivalent	Due in C\$	Total CGCP (C\$)	Change in Amount due in US\$	Change in CDN Equivalent	Change in Amount due in C\$
	----- \$'000 -----						
1993-94	3,438,102	4,772,086	-	-	-	-	-
1994-95	3,380,617	4,609,471	2,061,216	6,670,687	(57,485)	(162,615)	-
1995-96	3,343,769	4,597,348	1,924,515	6,521,862	(36,848)	(12,123)	(136,701)
1996-97	3,258,392	4,490,064	1,875,468	6,365,532	(85,377)	(107,284)	(49,047)
1997-98	3,385,624	5,118,726	1,814,834	6,933,560	127,233	628,662	(60,633)
1998-99	3,269,038	4,924,153	1,814,236	6,738,388	(116,586)	(194,573)	(599)
1999-00	3,575,915	5,317,386	1,768,444	7,085,831	306,877	393,233	(45,791)
2000-01	3,484,550	5,340,073	1,700,396	7,040,469	(91,366)	22,686	(68,048)
2001-02	3,335,449	5,279,682	1,594,682	6,874,364	(149,101)	(60,390)	(105,715)
2002-03	3,124,774	4,389,638	1,457,303	5,846,941	(210,675)	(890,044)	(137,379)
2003-04	2,957,844	3,932,454	1,285,977	5,218,431	(166,930)	(457,184)	(171,326)

Source: CWB Annual Report, Multiple Years

